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C O N F I D E N T I A L SECTION 01 OF 02 TEGUCIGALPA 001489

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SUBJECT: HONDURAN CENTRAL BANK PRESIDENT "QUIETLY DOING HER  
JOB."

Classified By: Ambassador Charles Ford for reasons 1.4 (b) and (d)

¶1. (C) Summary: Central Bank President Gabriela Nunez is content with Honduras' macro-economic situation, citing a stable exchange rate and declining inflation. Nunez was sanguine (perhaps too much so) on the likely impact on the economy of the recent mammoth wage increase granted by the GOH to teachers and its implications for the GOH's agreement with the International Monetary Fund. Nunez does not foresee a drop in remittances, nor pressure for a devaluation of the Honduran currency, the lempira. Nunez -- a likely future Presidential candidate -- recognizes the need for fiscal discipline, but has been reluctant to assume a public stance on the issue, in part because of the political clout teachers' unions wield in the electoral process. Nunez has concrete plans for gradual improvements in BCH operations, and would welcome proposed U.S. Treasury support on improving budgeting procedures. End Summary.

¶2. (C) In an August 11 meeting with Ambassador and EconChief, President of the Central Bank Gabriela Nunez expressed confidence in the state of the Honduran economy, and described her surprisingly low profile as "quietly doing my job." Nunez has previously been a Minister of Finance, and was one of the leading vote-getters in the Liberal Party primaries for President in 2005. It is widely expected Nunez will resign her position at the Central Bank of Honduras (BCH) over the next year or so and devote her efforts to another run for the Presidency. During the meeting, Nunez did not discuss her future plans, but her comments covered a wide range of policy issues and implicitly criticized the Zelaya team for some of its missteps.

¶3. (C) Asked whether she thought the exchange rate is overvalued (ostensibly a managed float within a seven percent band, but in reality held steady by the GOH at 18.895 lempiras per dollar for the last several months), Nunez said no. Falling inflation in Honduras and rising volumes of foreign exchange (forex) reserves (currently approaching USD 2.3 billion) have helped keep the lempira strong, as has the formula by which the GOH determines target exchange rates. That formula is based on the difference in inflation rates in the U.S. and Honduras, with a forex weighting included. The result, she said, has been a "practically stable" nominal exchange rate. Were the GOH to move to a flexible exchange rate regime, Nunez said, there would be pressure for the currency to appreciate, putting exporters at a competitive disadvantage. (Note: Exporters disagree that the currency would or should appreciate, noting that the formula used does

not eliminate the entire inflation differential and that, as a result, the real exchange rate has been eroding for over a decade. According to this view, the currency should depreciate, not appreciate. A colleague from the Embassy of Japan agrees, noting that previous investor delegations have declined to invest in Honduras, citing what they viewed as an overvalued currency. End note.)

14. (C) Nunez said that one of the few circumstances that could prompt a depreciation would be wholesale capital flight, which she sees as unlikely, given a solid macroeconomic framework and a halt to the increase of the interest rate spread between the U.S. and Honduran rates. (Honduran interest rates have dropped over 400 basis points this year to around 7 percent as the Central Bank has undersupplied the bond market and encouraged private banks to inject capital into the real economy. At the same time, U.S. interest rates over the last three years have risen from 0.75 percent to 5.25 percent, before the FOMC halt on August 8.) Her comments overlook other, more troubling developments, such as the growing fiscal laxity evident in the Zelaya Administration's increasingly populist tactics. While Post does not predict capital flight any time soon, we note that the increasingly anti-investment tenor of the GOH does not inspire investor confidence.

15. (C) On remittances (the key contributor to the forex buildup cited above), Nunez told Ambassador that she doubts slowing growth in the U.S. will decrease remittances. (Note: There are an estimated one million Hondurans living in the United States, who will send an estimated USD 1.5 to 2.0 billion this year in remittances to Honduras, equivalent to 25 percent of the Honduran GDP. The volume of remittance inflows has been rising 30 percent or more annually for several years, and now is the largest source of hard-currency

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earnings for Honduras. End note.) These remittances help the overall macroeconomic situation in Honduras, and spur economic growth through increased consumption, Nunez said. The multiplier effect of that increased consumption is muted, however, by the high percentage of consumer goods that are imported from abroad, especially the United States.

16. (C) On fiscal policies, Nunez said the next few months will be "critical" for the GOH, as the administration resolves pending wage bills for teachers and doctors, as well as identifying funding for proposed dramatically increased housing construction. (Nunez did not cite, but Post would add to that list: funding continuing subsidies to taxi and bus drivers; gasoline subsidies for consumers; massive losses at state-run electric company ENEE; and sharply dropping revenues at state-run phone company Hondutel.) Nunez cited as her chief concerns the need for increased efficiency in fiscal spending (getting more bang for the buck), and better budget formulation. She also agreed with previous public comments from her colleague, Minister of Finance Rebecca Santos, on the need to establish a reasoned debt policy, and to control the growth of public sector wages. (Comment: This remark was also an implied criticism of the Zelaya team's recent resolution of the teacher's strike, in which striking workers were awarded 7 billion lempiras -- nearly USD 380 million -- in increased wages and benefits. That raise could break the GOH's accord with the IMF; will almost certainly cripple other poverty reduction programs by diverting scarce resources; and will likely spur other unions to similar GOH-paralyzing strike tactics. End comment.)

17. (C) Focusing specifically on the teachers' wages issue, Nunez said the Zelaya administration is looking for a final solution, but "it's not easy." The teacher's union is powerful and disciplined. In a very revealing comment about the source of the teachers' strength, Nunez pointed out that the polling stations ("mesas electorales") are almost always in schools and are overwhelmingly staffed by teachers. Asked whether the agreement will break faith with the Fund, Nunez

told Ambassador that she believes the Fund could accept "five billion lempiras over six years." (Comment: Nunez has not publicly commented on the teachers' wage issue. Assuming her intention is to run for President again in 2009, her comment on polling stations likely explains this very low-profile stance. As to the Fund's views, Post finds it unlikely that the Fund will be nearly so blase about the deal. New IMF Resident Representative Mario Garza has only arrived in Honduras this week, and has not yet reviewed the details of the proposed deal. More to the point, the deal's timeframe has telescoped dramatically while its total cost has escalated, so that the GOH now faces a 7.2 billion lempira bill over just three years. That rate of public sector wage growth far exceeds GDP growth, almost certainly putting the GOH out of compliance with its agreed Fund targets for public sector wages. End comment.)

18. (C) Turning to her recent accomplishments and future goals, Nunez highlighted a range of activities. The BCH has moved to a two-year monetary policy, vice a one-year policy previously. Nunez also anticipates that the IMF fourth and fifth reviews will go well for Honduras ("assuming the teachers' wages issue is resolved"). Over the coming years Nunez wants to see the BCH move to an electronic auction of dollars; improved administration of reserves; improved investment rules; and the publishing of rules to support the development of an electronic payments system, starting with inter-bank transfers. Nunez said the BCH plans to begin publishing fiscal and Balance of Payments information next year, and will add the light industrial sector to its GDP calculations. Post will continue to work closely with Nunez, and is currently supporting a BCH-U.S. Treasury dialogue on the possibilities of Office of Technical Assistance (OTA) support for improved budgeting.

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